

**Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554**

Application by Qwest Communications	)	
International, Inc. for Authorization To	)	
Provide In-Region InterLATA Services	)	WC Docket No. 02-148
in the States of Colorado, Idaho, Iowa,	)	
Nebraska, and North Dakota	)	
	)	
	)	
Application by Qwest Communications	)	
International, Inc. for Authorization To	)	
Provide In-Region InterLATA Services	)	WC Docket No. 02-189
in the States of Montana, Utah,	)	
Washington, and Wyoming	)	

**COMMENTS OF QWEST COMMUNICATIONS INTERNATIONAL, INC.**

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Qwest Communications International Inc. ("Qwest" or "QCII") respectfully submits these comments in response to Public Notice DA 02-2129, released August 29, 2002, in the above-captioned dockets.

**INTRODUCTION AND SUMMARY**

In its applications in these proceedings, Qwest has provided a detailed showing consistent with those approved in prior 271 applications that its designated section 272 affiliate, Qwest Communications Corporation ("QCC"), will comply with each of the requirements of section 272, including the requirement of section 272(b)(2) that it will maintain its books, records, and accounts in the manner prescribed by the Commission.<sup>1</sup> At the request of the Multistate Facilitator in Qwest's region, Qwest also retained KPMG LLP ("KPMG") to verify that showing in late 2001. KPMG confirmed, based on its

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<sup>1</sup> 47 U.S.C. § 272(b)(2). See Declarations of Judith L. Brunsting and Marie E. Schwartz (June 13, 2002, and July 12, 2002).

review of specific QCC transactions with Qwest Corporation (“QC”), the BOC, that Qwest had implemented controls designed to ensure compliance with section 272(b)(2) and other requirements of section 272.<sup>2</sup> All nine state commissions in these proceedings have reviewed this evidence and concluded that Qwest’s 271 authorizations “will be carried out in accordance with the requirements of section 272.”<sup>3</sup>

The issues discussed in the Public Notice, which Qwest itself brought to the Commission’s attention, do not make the states’ unanimous conclusion incorrect. As part of an ongoing review of Qwest’s accounting policies and practices, Qwest (working with KPMG) recently identified a number of past transactions by QCC that may not have been accounted for correctly.<sup>4</sup> As set forth in the attached KPMG Report, none of the transactions identified for potential restatement during this review<sup>5</sup> were direct affiliate transactions between QC and QCC.

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<sup>2</sup> See, e.g., Declarations of Marie E. Schwartz ¶¶ 23-27 (June 13, 2002 and July 12, 2002); *id.* exs. MES-272-3 (KPMG LLP Report, Nov. 9, 2001, associated cover brief and Schwartz affidavit) and MES-272-4 (Jacobsen KPMG Declaration, Dec. 14, 2001); Declaration of Judith L. Brunsting ¶¶ 58-61 (June 13, 2002), Declaration of Judith L. Brunsting ¶¶ 59-62 (July 12, 2002); *id.* ex. JLB-272-17 (Brunsting affidavit to June 13 and July 12, 2002, Brunsting declarations).

<sup>3</sup> 47 U.S.C. § 271(d)(3)(B).

<sup>4</sup> These comments focus on QCC’s past transactions because these are the only ones that potentially have any bearing on Qwest’s application. By statute, the only transactions of QC that are relevant to section 272 are those between it and QCC. See 47 U.S.C. § 272(c)(2). Although Qwest, as it advised the Commission and the SEC, see *Shaffer August 26 Ex Parte* at 2; SEC Form 8-K (filed Aug. 19, 2002), is in the process of reviewing QC’s past transactions as well, and will soon state whether any of QC’s accounting for those transactions needs to be adjusted, the attached supplemental KPMG report described below confirms that none of those potential adjustments would involve direct affiliate transactions with QCC. They are thus not relevant for purposes of section 272(c)(2).

<sup>5</sup> Any requirement to restate QCII’s SEC financial statements would also require restatement with respect to items that would otherwise not be material for such purposes. Thus, as noted in part III below, it would include one item Qwest had *previously* identified and reported in connection with its ARMIS report in April 2002. This involved an adjustment to the year in which revenues or expenses between QCC and QC were recorded, which as noted below has already been made on the books, records, and accounts of QCC and which may not otherwise have been required to be restated in QCII’s financial statements.

QCII provided an interim report on this review process in a Form 8-K filed with the Securities and Exchange Commission on July 29, 2002.<sup>6</sup> The SEC filing discussed four different categories of transactions that may require restatement, three of which (optical capacity sales, sales of equipment, and receipts of services from other telecommunications providers) included transactions by QCC. The filing also stated that QCII and KPMG were continuing to review other categories of transactions. Based on the four categories of transactions identified, QCII reached a judgment that it was currently unable to certify that QCII's SEC-filed financial statements were prepared in accordance with generally accepted accounting principles ("GAAP").<sup>7</sup>

Because QCC has been designated QCII's section 272 affiliate, QCII believed it appropriate to disclose this development to the Commission.<sup>8</sup> However, Qwest believes that it does not prevent the Commission from making the *prospective* determination in 47 U.S.C. § 271(d)(3)(B) that Qwest's requested interLATA authorizations "*will be carried out in accordance with the requirements of section 272*"<sup>9</sup> or, indeed, calls Qwest's *present* compliance with section 272 into question. Nor is there anything that undermines

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<sup>6</sup> SEC Form 8-K (filed July 29, 2002).

<sup>7</sup> In letters filed with the Commission on August 20 and August 26, 2002, QCII's Chief Financial Officer also referred to QCII's inability to certify the financial statements of QCC. *See* Verified Letter from Oren G. Shaffer, Vice Chairman and Chief Financial Officer, Qwest Communications International Inc., to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Dkt. Nos. 02-148 and 02-189 at 1 (filed Aug. 26, 2002) ("*Shaffer August 26 Ex Parte Letter*"); Letter from Oren G. Shaffer, Vice Chairman and Chief Financial Officer, Qwest Communications International Inc., to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Dkt. Nos. 02-148 and 02-189 at 2 (filed Aug. 20, 2002) ("*Shaffer August 20 Ex Parte Letter*"). This reference should have been to QCII, not QCC, whose operations are consolidated for reporting purposes with those of all other QCII affiliates. Only companies that are required to make periodic filings under the federal securities laws (generally either public companies or companies that have SEC registered securities) are required to file and certify financial statements with the SEC, and the only subsidiary of QCII that is required to make these filings is QC. For this reason, while QCC has prepared and filed (on a confidential basis) unaudited balance sheets with its 271 applications, and also on a confidential basis with certain state commissions in order to obtain the required certificates of operating authority, there are no certified financial statements for QCC.

<sup>8</sup> *See generally Shaffer August 20 Ex Parte Letter.*

<sup>9</sup> 47 U.S.C. § 271(d)(3)(B) (emphasis added).

the unanimous conclusions of all nine state commissions here that Qwest has presented substantial record evidence demonstrating that it will provide interLATA service in accordance with section 272. As Commissioner Rowe has noted in his comments, and in light of the results of KPMG's prior evaluation, "In this instance, restatement is not related to compliance with the separate affiliate requirements of Section [272]."<sup>10</sup> The Nebraska Commission agrees that "Qwest, and particularly its new management, is committed to maintaining its books, records and accounts, and those of its affiliates, in accordance with GAAP."<sup>11</sup> The Iowa Utilities Board agrees.<sup>12</sup>

The provisions of section 272 that define QC's and QCC's accounting obligations (47 U.S.C. §§ 272(c)(2) and (b)(2) respectively) both delegate the task of defining the content of those obligations to the Commission, and the Commission has in turn required compliance with GAAP. Congress expressly stated that only BOC transactions with their 272 affiliates were relevant for section 272(c)(2), and as noted above KPMG's 2001 review has provided compelling evidence that all such transactions in this case were GAAP-compliant. With respect to section 272(b)(2) (governing the 272 affiliate's obligations), both Congress and the Commission have been silent as to what transactions are covered; however, the Commission can interpret its own requirement of GAAP compliance to be consistent with the anti-cross-subsidization and anti-discrimination policies underlying section 272, and it should likewise focus its consideration on QCC's transactions with QC. In any event, the Commission need not reach this legal question,

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<sup>10</sup> Letter from Commissioner Bob Rowe, Sept. 4, 2002 at 2, Montana Public Service Commission, to Marlene H. Dortch, Secretary, Federal Communications Commission, WC Docket Nos. 02-148 and 02-189 (filed Sept. 4, 2002) ("Rowe Letter").

<sup>11</sup> Comments of the Nebraska Public Service Commission, WC Docket Nos. 02-148 and 02-189 (Sept. 3, 2002).

<sup>12</sup> Comments of the Iowa Utilities Board, WC Docket Nos. 02-148 and 02-189 (Sept. 4, 2002).

since QCII's recent filings demonstrate that QCC now maintains its books, records, and accounts for current transactions in accordance with GAAP.

As Commissioner Rowe has noted, there is nothing about Qwest's present inability to certify QC's and QCII's SEC-filed financial statements that precludes the Commission's ability to find Qwest in compliance with section 272. Like the Securities Exchange Act of 1934 and other statutes, the Communications Act repeatedly distinguishes between "books, records, and accounts" on the one hand and "financial statements" on the other, and only the former are relevant to section 272. The Commission's application of section 272 should thus focus on the general ledger, the chart of accounts, and those other records maintained on a day-to-day basis. Those are the records reflecting individual transactions that provide the kind of audit trail necessary (in the biennial review or otherwise) for identifying any improper cross-subsidization or discrimination by the BOC. In contrast, periodic and aggregated financial statements prepared for the benefit of the investing public are not designed to serve that function, and are not necessary for that purpose.

The Commission can make the predictive judgment that QCC will maintain such books, records, and accounts in accordance with GAAP because QCII and its new auditor have recently verified, and already implemented a number of additional controls designed to ensure, the present and future use of such accounting procedures. This is not to say, of course, that in implementing these controls QCC will be free from error. But that is not the standard of section 272(b)(2). Just as the securities laws require the implementation of controls that provide "reasonable assurances" of compliance with GAAP,<sup>13</sup> this

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<sup>13</sup> See 15 U.S.C. § 78m(b)(2)(B).

Commission asks whether QCC “has implemented internal control mechanisms reasonably designed to prevent, as well as detect and correct, any noncompliance with section 272.”<sup>14</sup> And given the priority this matter has necessarily taken with QCII’s new management team, QCC’s present practice of ensuring that it maintains its books, records, and accounts in accordance with GAAP permits the Commission to make the predictive judgment required by section 271.

In making that judgment, the Commission can rely on substantial evidence for finding prospectively that Qwest’s interLATA authorizations “will be carried out in accordance with the requirements of section 272.” In light of the policies underlying section 272, the past and present experience that is most probative here is Qwest’s again-confirmed record of compliance with respect to the affiliate transactions to which section 272 is directed, as well as its controls designed to ensure that present and future transactions are accounted for in accordance with GAAP.

## **DISCUSSION**

### **I. THE COMMISSION CAN AND SHOULD CLARIFY THAT ITS RULES IMPLEMENTING SECTION 272(B)(2) APPLY ONLY WITH RESPECT TO TRANSACTIONS BETWEEN THE SECTION 272 AFFILIATE AND THE BOC.**

In section 272, Congress expressly committed the question of what accounting standards a BOC and its affiliate must follow to the discretion of the Commission. Section 272(c)(2), applicable to the BOC, defines *which transactions* are relevant (only those with the section 272 affiliate) but leaves the standard for evaluating the accounting

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<sup>14</sup> Memorandum Opinion and Order, *Application by SBC Communications Inc., Southwestern Bell Tel. Co., and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-region, InterLATA Services in Texas*, 15 FCC Rcd 18354, 18549-50 ¶ 398 (2000) (“SBC Texas Order”).



of those transactions to the Commission's discretion: The BOC "shall account for all transactions with an affiliate described in subsection (a) in accordance with accounting principles designated or approved by the Commission."<sup>15</sup> Section 272(b)(2), governing the affiliate, contains an even broader delegation of discretion: The affiliate "shall maintain books, records, and accounts in the manner prescribed by the Commission," subject only to the requirement that they be "separate from the books, records, and accounts maintained by the Bell operating company of which it is an affiliate."<sup>16</sup> Not only does section 272(b)(2) leave the question of *which accounting principles* to the Commission's determination (as with section 272(c)(2)), it also leaves the definitions of *which transactions* and *which books, records, and accounts* to the Commission's discretion.

The Commission has exercised (and should continue to exercise) its delegated discretion in accordance with the core purposes of section 272. *See, e.g., Dickerson v. New Banner Inst.*, 460 U.S. 103, 118 (1983) (statutes must be interpreted "in light of the purposes Congress sought to serve"); Memorandum Opinion and Order, *Application of Fox Television Stations, Inc.*, 10 FCC Rcd 8452, 8470 ¶ 41 (1995) (noting that in construing Act, "our task is to interpret the words of the statute in light of the purpose Congress sought to serve") (citing *Dickerson*). As the Commission has repeatedly acknowledged, section 272's safeguards are intended to "ensure that BOCs do not discriminate in favor of their section 272 affiliates" by "discourag[ing] and facilitat[ing]

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<sup>15</sup> 47 U.S.C. § 272(c)(2). The "accounting principles designated or approved by the Commission" in this context include GAAP. *See* Report and Order, *Implementation of the Telecommunications Act of 1996: Accounting Safeguards Under the Telecommunications Act of 1996*, 11 FCC Rcd 17539, 17558-59 ¶ 44, 17586 ¶ 108 (1996) ("Accounting Safeguards Order"); 47 C.F.R. §§ 32.1, 32.12.

<sup>16</sup> 47 U.S.C. § 272(b)(2). There is no question here about QCC's compliance with the "separate" books, records, and accounts requirement.

the detection of . . . improper cost allocation and cross-subsidization between the BOC and its section 272 affiliate.”<sup>17</sup> Section 272 fits within, and takes its meaning from, section 271’s broader purpose of “promot[ing] competition in all telecommunications markets” by “seek[ing] to ensure that competitors of the BOCs will have nondiscriminatory access to essential inputs on terms that do not favor the BOC’s affiliate.”<sup>18</sup> With these purposes in mind, the Commission has implemented sections 272(b)(2) and (c)(2) by requiring the BOC and its section 272 affiliate to maintain their books, records, and accounts “in accordance with GAAP”; the requirement serves the statutory purposes by yielding “a uniform audit trail at minimal cost.”<sup>19</sup>

But while the Commission has answered the question of *which accounting principles* should be applied for QCC (GAAP, as opposed to the Part 32 rules or some other principles of accounting<sup>20</sup>), it has never directly answered the questions relevant here: *which transactions* of the affiliate must comply with GAAP, and *which books, records, and accounts* are relevant for the section 271 inquiry. (Again, section 272(c)(2) specifies the answer with respect to the BOC: “transactions with an affiliate described in subsection (a)” and the records accounting therefor.) These questions must also be

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<sup>17</sup> Memorandum Opinion and Order, *Joint Application by SBC Communications Inc., Southwestern Bell Tel. Co., and Southwestern Bell Communications Services, Inc. d/b/a Southwestern Bell Long Distance Pursuant to Section 271 of the Telecommunications Act of 1996 To Provide In-Region, InterLATA Services in Arkansas and Missouri*, 16 FCC Rcd 20719, 20780 ¶ 122 (2001) (“SBC Arkansas/Missouri Order”); Memorandum Opinion and order, *Application of Ameritech Michigan Pursuant to Section 271 of the Communications Act of 1934, as Amended, To Provide In-Region, InterLATA Services in Michigan*, 12 FCC Rcd 20543, 20725 ¶ 346 (1997) (“Ameritech Michigan Order”). See also *Accounting Safeguards Order* at 17582-83 ¶ 101 (separate affiliate requirements, including section 272, “limit the carrier’s ability to engage in cross-subsidization and discrimination, and enhance the ability of the Commission or a State to detect cross-subsidization and discrimination”).

<sup>18</sup> *Ameritech Michigan Order* at 20725 ¶ 346.

<sup>19</sup> *Accounting Safeguards Order* at 17618 ¶ 170.

<sup>20</sup> See *Accounting Safeguards Order* at 17618 ¶ 170 (rejecting commenters’ suggestion that section 272 affiliates be required to follow the Commission’s Part 32 accounting rules).

answered with reference to the purposes of section 272. The only transactions of the section 272 affiliate that have any relevance to the concerns underlying section 272 are those between the affiliate and the related BOC, since those are the only ones that present any potential issue of cross-subsidization or unfair advantage provided by the BOC to the section 272 affiliate. Interpreting the scope of the affiliate's section 272(b)(2) obligations *in pari materia* with the BOC's section 272(c)(2) obligations is also consistent with the Commission's stated goal of establishing a "uniform audit trail" between the two entities for their transactions with each other.<sup>21</sup> Indeed, the Commission took this language from a commenter that had advocated GAAP specifically for accounting of transactions "between a BOC and its affiliates," on the ground that it was the symmetrical treatment of BOC and affiliate transactions that created "a more uniform audit trail."<sup>22</sup>

By contrast, construing section 272(b)(2) more broadly to apply to transactions with unaffiliated third parties does not further any of the purposes of section 272 (or section 271). Transactions between QCC and third parties obviously present no means for the BOC to cross-subsidize QCC. Nor do they present any risk of BOC discrimination in favor of its 272 affiliate. These transactions with third parties also have no relevance to the fundamental concerns of the section 271 (and, in particular, 271(d)(3)(B)) inquiry: whether the market is open to competition by virtue of all competitors having "nondiscriminatory access to essential inputs on terms that do not favor the BOC's affiliate."<sup>23</sup> Stretching section 272(b)(2) to cover QCC's third-party transactions would take the Commission far afield of any concern of section 271 or 272

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<sup>21</sup> *Id.*

<sup>22</sup> See Comments of Telecommunications Resellers Ass'n ("TRA") at 6 (Aug. 26, 1996); *Accounting Safeguards Order* at 17617-18 ¶¶ 168, 170 (citing comments of TRA).

<sup>23</sup> *Ameritech Michigan Order* at 20725 ¶ 346.

the Commission has articulated to date, and far beyond what Congress anticipated in drafting section 272.

**II. NOTWITHSTANDING ITS PRESENT INABILITY TO CERTIFY ITS FINANCIAL STATEMENTS, QCII HAS DEMONSTRATED THAT QCC CURRENTLY MAINTAINS ITS BOOKS, RECORDS, AND ACCOUNTS IN ACCORDANCE WITH THE COMMISSION'S REQUIREMENTS.**

Qwest's current inability to certify that its publicly filed financial statements comply with GAAP is both legally and factually irrelevant to the Commission's section 272 determination. As a legal matter, the Commission can and should construe the term "books, records, and accounts" in section 272(b)(2) that are maintained by the 272 affiliate to be separate from financial statements its parent company prepares and files with the SEC. Congress explicitly distinguishes throughout the Act between the "preparation" of periodic, aggregated "financial statements" such as quarterly and annual reports and "maintenance" of the underlying "books, records, and accounts" that yield the transaction-by-transaction and day-by-day data from which those statements are compiled. For example, the provisions of the Act requiring separate affiliates for BOC electronic publishing activities require the affiliates to "maintain separate books, records, and accounts *and prepare separate financial statements.*"<sup>24</sup> Similarly, a public telecommunications entity that receives funds from the Corporation for Public Broadcasting must "keep its books, records, and accounts in such form as may be required by the Corporation" and subject them to periodic audit, or may *alternatively* "submit a financial statement in lieu of the audit" if the Corporation so permits.<sup>25</sup> Where Congress intended to impose standards or obligations with respect to financial statements,

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<sup>24</sup> 47 U.S.C. § 274(b)(1) (emphasis added).

<sup>25</sup> 47 U.S.C. §§ 396(l)(3)(B)(i), (ii), (II).

it referred to such statements explicitly; Congress's usage makes plain that these statements are not included in the term "books, records, and accounts."

The distinction between "financial statements" and "books, records, and accounts" in the Communications Act parallels the same distinction in the Securities Exchange Act of 1934 ("SEA") and other non-communications statutes.<sup>26</sup> For example, the SEA expressly distinguishes between "mak[ing] and keep[ing]" transaction-by-transaction "books, records, and accounts" on the one hand, and "preparation of financial statements" aggregated and abstracted from this transaction data on the other:

Every issuer which has a class of securities registered pursuant to section 78l of this title and every issuer which is required to file reports pursuant to section 78o(d) of this title shall--

- A. *make and keep books, records, and accounts*, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- B. devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that—
  - i. transactions are executed in accordance with management's general or specific authorization;
  - ii. transactions are recorded as necessary (I) to permit *preparation of financial statements* in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;
  - iii. access to assets is permitted only in accordance with management's general or specific authorization; and

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<sup>26</sup> These non-communications statutory provisions are relevant not only because of the similarities in language between these provisions and section 272(b)(2), but also because the Commission has a self-acknowledged duty to implement the Communications Act so as to be consistent with federal securities and corporate law policies. *See Macfadden Acquisition Corp.*, 104 F.C.C.2d 545, 559-60 ¶ 26 (1986); *see also LaRose v. FCC*, 494 F.2d 1145 (D.C. Cir. 1974).

- iv. the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.<sup>27</sup>

Similarly, the provisions of the Labor-Management Reporting and Disclosure Act giving union members rights to inspect their unions' financial records refer separately to the annual "financial report" that each union files and the "books, records, and accounts" from which the report is drawn.<sup>28</sup> The distinction incorporated in each of these statutes is one that is well recognized in the accounting profession. As a leading text confirms, "journals, ledgers, and computer files," as well as "memoranda and worksheets supporting such items as cost allocations, computations, and reconciliations," form the "*underlying accounting data*" that serves as the "evidential matter necessary to support the assertions in the financial statements."<sup>29</sup>

Like these other statutes, and consistent with these established accounting principles, the Commission should interpret the term "books, records, and accounts" in section 272(b)(2) to refer to the systems for recording immediate transactional data — such as the general ledger, charts of accounts, and asset disposition records. Indeed, these are the types of records the Commission has asked to review in connection with

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<sup>27</sup> 15 U.S.C. § 78(m)(b)(2) (emphases added). *See generally* Gary Brown, Exchange Act Registration and Reporting, 1310 PLI/Corp 55, 105-108 (2002) (provision "imposes a statutory requirement that the company maintain proper *internal books and records*, which requirement is *in addition* to the company's obligations relating to its filed or otherwise publicly disclosed financial statements") (emphases added). *See also* SEC v. *World-Wide Coin Invs., Ltd.*, 567 F. Supp. 724, 748 (N.D. Ga. 1983) (books and records "permit the preparation of financial statements"); *cf.* *United States v. Crop Growers Corp.*, 954 F. Supp. 335 (D.D.C. 1997) (dictum) (although financial statements may not warrant differential treatment, claim was dismissed because venue based on location of books, records, and accounts could not be premised on location of filing of financial statements).

<sup>28</sup> 29 U.S.C. § 431(c); *see Kinslow v. Amn. Postal Workers*, 222 F.3d 269 (7th Cir. 2000).

<sup>29</sup> Vincent O'Reilly *et al.*, *Montgomery's Auditing* at 133 (11th ed. 1990) (citing SAS No. 31) (emphasis in original). *Accord*, Larry Bailey, 2002 Miller GAAS Guide § 326, at 152.

previous section 271 applications.<sup>30</sup> Applying this term to transaction records, and not to aggregated financial statements, also makes sense in light of the policies underlying section 272. The “books, records, and accounts” of individual BOC and affiliate transactions provide the kind of “audit trail” necessary to enable a reviewing party to determine whether the BOC is improperly benefiting its affiliate (the core concern of section 272), while aggregated and episodic “financial statements” provide no information in this regard. Conversely, stretching section 272(b)(2) to cover publicly reported financial statements would serve no section 272 or 271 purpose at all. It would turn the Commission into a duplicative auditor of Bell companies’ publicly reported financial statements and SEC filings for compliance with GAAP for the benefit of investors — a role, of course, vested by Congress through the SEA in the SEC itself.

As Qwest Chief Financial Officer Oren Shaffer noted in his August 26 letter,<sup>31</sup> Qwest’s present financial statements build on prior transactions. Thus, even if all current transactions are booked, recorded, and accounted for correctly, the effects of past transactions necessarily result in errors in the current statements (and in the underlying general ledger). Because Qwest is in the process of restating its prior quarters’ financial results to bring them in compliance with GAAP, it cannot certify any financial statements that reflect its past accounting practices, even though Qwest is accounting for all new transactions today in accordance with GAAP, and thus meeting the Commission’s requirements for section 272(b)(2).

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<sup>30</sup> For example, the Commission asked SBC to submit a copy of its chart of accounts in connection with its Texas application and relied on that chart, together with information about SBC’s accounting controls, to find SBC in compliance with section 272(b)(2) and GAAP. *See SBC Texas Order* at 18550-51 ¶ 400 & n.1163.

<sup>31</sup> *See Shaffer August 26 Ex Parte Letter* at 1-2.

These problems in accounting for past transactions do not demonstrate that QCC is currently failing to “maintain” its “books, records, and accounts” as required by section 272(b)(2). First, the only “books, records, and accounts” that are even affected by these past transactions are QCC’s general ledger and individual subsidiary ledgers relative to the potential restatements. Even as to the ledgers, Qwest is presently making entries for all new transactions in accordance with GAAP. Section 272(b)(2) requires only that the section 272 affiliate “*shall* maintain” its accounts in accordance with Commission rules going forward; it does not require the affiliate to prove that it “has maintained” its records in accordance with GAAP for all times past.

Construing section 272’s obligation to “maintain” records in terms of recording transactions properly rather than having correct ledger balances at any given time best comports with the policies underlying section 272. As stated above, the point of section 272 is to enable reviewing parties to detect and prevent improper dealings between the BOC and the affiliate. It is the individual transaction entries -- at the account and subaccount level -- that provide the “audit trail” that the Commission has concluded is necessary to do this, not the aggregated ledger balances. Even if the starting balance in a review period is in error in a past period, that does not affect the reviewer’s ability to construct the necessary audit trail from the individual transaction record entries in the period under consideration.

A contrary rule would lead to results that could not have been consistent with congressional intent. The balance in a company’s ledger could well be off at any given point in time as a result of data entry errors, booking errors, or other mistakes. It cannot be the case that any discrepancy in the company’s books puts the company out of



compliance with section 272(b)(2), thereby subjecting the company (if these discrepancies arise after section 271 approval) to potential sanctions under 47 U.S.C. § 271(d)(6). On the contrary, the Commission asks whether the applicant “has implemented internal control mechanisms reasonably designed to prevent, *as well as detect and correct*, any noncompliance.”<sup>32</sup> The Commission correctly acknowledges that there could be errors in a section 271 applicant’s books, records, and accounts at any given point in time. What matters is that the applicant has reasonable controls in place to “detect and correct” them.

For these reasons, Mr. Shaffer has confirmed Qwest’s prior testimony that, notwithstanding the need for restatement of financial statements, QCC is “maintaining [its] books, records, and accounts in accordance with GAAP.”<sup>33</sup> In light of Mr. Shaffer’s relatively recent tenure at Qwest, the Commission has asked Qwest to provide the basis for Mr. Shaffer’s statement with respect to QCC’s current and future practices. As we show below, Mr. Shaffer’s judgment is that of an experienced Chief Financial Officer, premised upon his review and approval of specific changes made at QCC over the course of the past two months.

Prior to his appointment as QCII’s Chief Financial Officer in July 2002, Mr. Shaffer had served for approximately six years as Chief Financial Officer of Ameritech Corporation, until its merger with SBC. Prior to that time, he served as Chief Financial Officer of Goodyear Tire and Rubber Company. Since being appointed to his current position by new management at QCII, and in light of the current SEC investigation, Mr.

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<sup>32</sup> *SBC Texas Order* at 18549-50 ¶ 398 (emphasis added).

<sup>33</sup> *Shaffer August 26 Ex Parte Letter* at 1.

Shaffer has devoted significant time and effort to the question of QCC's past practices in accounting for the kinds of transactions identified in its July 29 SEC Form 8K.

In the course of discharging this responsibility, Mr. Shaffer has required and reviewed regular reports from KPMG and its Senior Vice President - Accounting and Financial Operations ("SVP"). Under his supervision, the SVP has recently completed a two-month process of reconciliation, involving approximately 4500 individual accounts in QCII's general ledgers (including those of QCC), and established a process of ongoing monitoring of its balance sheet accounts. Mr. Shaffer has also relied upon the retention of approximately 20 experienced consultants in order to ensure the sufficiency of accounting resources to properly account for new transactions, and the creation of a new Projects and Analysis Group responsible for establishing and managing the accuracy of Qwest's books, records, and accounts and implementing internal control enhancements. He has overseen the transfer of supervision over accounting functions from business units to the SVP, the hiring of an experienced Assistant Controller, an increase in staffing in the technical accounting group, and the consolidation of accounting responsibilities for cash, accounts receivable, assets, revenues, and other functions. He has also approved the elevation of the controller function to become the SVP.

Based upon his professional review of these processes and the institution of these changes, his judgment forms a reliable basis for predicting that QCC now maintains, and will maintain, its books, records, and accounts in accordance with GAAP. While these changes will not ensure that QCC will account for all new transactions correctly, they are "reasonably designed to prevent, as well as detect and correct, any noncompliance with

section 272[(b)(2)].”<sup>34</sup> As with the SEA,<sup>35</sup> that is all that the Commission requires going forward.

### **III. QCC’S RECORD OF COMPLIANCE WITH RESPECT TO ITS TRANSACTIONS WITH QC, COMBINED WITH ITS ADOPTION OF THE FOREGOING CHANGES, JUSTIFIES A POSITIVE SECTION 272 FINDING.**

Section 271(d)(3)(B) explicitly calls on the Commission to make a *prospective* finding: the Commission must determine whether the BOC’s “requested authorization *will be* carried out in accordance with the requirements of section 272”<sup>36</sup> The Commission has acknowledged that it is required to make what is “in essence a predictive judgment regarding the future behavior of the BOC.”<sup>37</sup> In this regard, the Commission has stated that it “will look to past and present behavior of the BOC applicant as the best indicator of whether it will carry out the requested authorization in compliance with the requirements of section 272.”<sup>38</sup>

As laid out above, Qwest believes that the transactions between QC and QCC are the only ones that are relevant to the section 272 inquiries as a matter of law. But if the Commission does not find that section 272(b) should be so construed, these same affiliate transactions are clearly the most probative “past and present behavior” for the Commission’s predictive judgment under section 271(b)(3). As the Nebraska

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<sup>34</sup> *SBC Texas Order* at 18549-50 ¶ 398.

<sup>35</sup> *See* 15 U.S.C. § 78m(b)(2) (requirement of “reasonable assurances”).

<sup>36</sup> 47 U.S.C. § 271(d)(3)(B) (emphasis added). By contrast, all the other determinations the Commission makes are phrased in terms of present compliance. *See id.* § 271(d)(3)(A)(i) (asking whether the BOC “*has fully implemented* the competitive checklist”) (emphasis added); § 271(d)(3)(C) (asking whether grant of the BOC’s application “*is consistent with the public interest, convenience, and necessity*”) (emphasis added).

<sup>37</sup> *Ameritech Michigan Order* at 20725 ¶ 347.

<sup>38</sup> *Id.*

Commission, the Iowa Board, and Commissioner Rowe have noted in their comments, Qwest's past and present record in this regard provides substantial evidence in support of an affirmative determination here. Unlike for any previous BOC's application, the Commission has the benefit of an independent accounting firm's assessment of Qwest's section 272 compliance. As noted above, Qwest engaged KPMG in late 2001 as part of the state review process to independently assess Qwest's compliance with the accounting-related requirements of section 272 (including section 272(b)(2)) and the Commission's Part 32.27 affiliate transaction rules. Qwest corrected all discrepancies identified in this first review (all but one of which Qwest itself had previously identified) and implemented further controls designed to ensure affiliate transactions were accounted for correctly. Qwest retained KPMG a second time in December 2001 to confirm that Qwest had corrected all the discrepancies that KPMG had identified earlier and to verify that Qwest's controls were reasonably designed to prevent and detect any future non-compliance in QC's and QCC's transactions with each other. KPMG confirmed both these points,<sup>39</sup> and all nine of the state commissions involved in these dockets have found Qwest in compliance with section 272.

At the Commission's request QCII recently retained KPMG to undertake yet one more verification with respect to QCII's conclusions that QC-QCC transactions are being accounted for in accordance with GAAP. As the accompanying further report from KPMG attached to these comments demonstrate, during the course of its recent review KPMG has identified no direct transactions between QC and QCC that have caused it to believe that management's assertion on this question is not fairly stated, in all material

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<sup>39</sup> See note 2 *supra* (citing Jacobsen KPMG Declaration of December 14, 2001).

respects. Of the potential restatement items identified for purposes of financial statements to be filed with the SEC, only one would involve a direct QC-QCC transaction. And this transaction has already been reflected on QCC's books, records, and accounts. This item involves an adjustment (relative to the year in which revenues or expenses were previously booked) that has previously been filed in an amendment dated April 30, 2002, to the annual ARMIS filings made by QC. It was identified by QC and QCC, and thus provides further validation of the effectiveness of the foregoing controls previously verified by KPMG. It was booked by that date to the general ledger. And while it may be included in any restatement of QC's financial statements together with other matters (and if so only because of the existence of those other matters), QCC's books, records, and accounts already properly account for it pursuant to these controls.

Here, QCC's record of past compliance in establishing (with the assistance of KPMG) a system of controls governing the affiliate transactions that lie at the core of section 272 is coupled with a demonstration that QCC has also implemented procedures reasonably designed to ensure that its books, records, and accounts related to transactions with all parties will be maintained in accordance with GAAP. Thus, its most probative present as well as past behavior provides substantial evidence in support of a predictive judgment that Qwest's requested section 271 authorizations "will be carried out in accordance with the requirements of section 272." The thorough and ongoing review of Qwest's prior accounting practices now being undertaken by new management provides further support for the reliability of these commitments. And as the Commission has noted in previous section 271 orders,<sup>40</sup> section 272(d)'s provision for biennial audits

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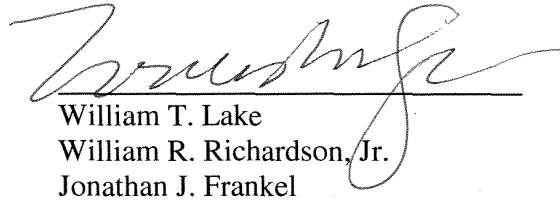
<sup>40</sup> See, e.g., Memorandum Opinion and Order, *Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in*

serves as an additional check on the validity of its predictive judgment that the 271 authorization will be carried out in accordance with section 272(b)(2).

### **CONCLUSION**

For the reasons set forth above, the Commission can and should make the predictive judgment that QCC will carry out its section 271 authority in accordance with the requirements of section 272, including section 272(b)(2).

Respectfully submitted,



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